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ABSTRACT

Implications for colleges and universities of a proposed new audit guide for Office of Management and the Budget (OMB) Circular A-110 are considered. The Department of Health and Human Services (HHS) is considering issuance of an audit guide that will outline procedures to be followed to comply with the audit requirement in Circular A-110. With such a guide, HHS audit work previously done by the agency might be shifted to colleges and universities. It is suggested that although HHS officials initially assured auditors they would be able to exercise professional judgment in conducting the student financial aid audits, experience to date has indicated the opposite. Many regional audit agencies are treating these guides as if they were law and have required compliance with every detailed step. It is claimed that a balance between quality and cost effectiveness is needed. One way to assure some degree of equity among institutions is to relate the percentage of resources spent on A-110 audits to sponsored research volume. It is proposed that under ideal circumstances an audit guide would: be under the auspices of OMB; with the audit procedure, be voluntary; completely satisfy A-110 requirements; not be subject to frequent changes; allow the accountants or state auditors to exercise judgment in the selection of areas to evaluate and to determine the extent of testing necessary in the circumstances; and permit internal audit departments with a high level of independence to do A-110 audits. Developments since 1976 that pertain to audits of higher education institutions are also traced. (SW)

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A-110: Do We Need Another Audit Guide?

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by WARREN H. SPRUILL

Because events are developing very rapidly, this article can serve only as a status report. The possible expansion of the audit requirement in OMB Circular A-110 would unnecessarily increase audit costs. Both NACUBO and its Council on Governmental Relations (COGR) are active in trying to avoid, or at least to minimize, this development.

The Department of Health and Human Services (HHS) is considering issuance of an audit guide that will outline procedures to be followed to comply with the audit requirement in Circular A-110. With such a guide, HHS audit work previously done by the agency might be shifted to colleges and universities. This development should concern auditors and business officers for at least three reasons: (1) the four years of experience with the student financial aid audit guides has shown just how difficult and expensive it is to comply with federal audit guides; (2) it is highly questionable whether a single audit guide is appropriate, given the diversity of institutions with varying amounts of sponsored research; and (3) the question of whether use of the guide will be compulsory, and, if so, under what authority, must be examined carefully.

Attachment F of Circular A-110 lists standards for financial management systems. One of those standards, Paragraph h., requires examination in the form of audits or internal audits.

"These examinations are intended to ascertain the effectiveness of the financial management systems and internal procedures that have been established to meet the terms and conditions of the agreements. It is not intended that each agreement awarded to the recipient be examined. Generally, examinations should be conducted on an organizationwide basis to test the fiscal integrity of financial transactions, as well as compliance with the terms and conditions of the federal grants and other agreements."

Before 1976, when A-110 was being drafted, many educational institutions did not have effective audits. The drafters of A-110 recognized this shortcoming and incorporated an audit standard to improve the internal control systems of colleges and universities. It appears this standard was included to help institutions manage themselves. The original version of A-110 was in the July 30, 1976 *Federal Register*, page 32018. It did not require institutions to submit audit reports to the federal government. HEW implemented its version of A-110 in the August 2, 1978 *Federal Register*, page 34078 and added in Subpart H,h(6) that "a copy of each audit report and a description of its resolution shall be furnished to the appropriate regional office of the HEW Audit Agency." HEW responded to reviewers' criticism of this addition by stating:

"*Response.* HEW did not interpret the circular as prohibiting this requirement: OMB agrees. . . . In addition, as a result of this change, the HEW Audit Agency will have a copy of every audit report and, to the extent that it can rely upon the reports, may be able to reduce the frequency and scope of direct Federal audits. (74.61(h))"

The added italics emphasizes that HEW did not interpret the standard as giving it authority to shift its audit responsibilities to colleges and universities.

On May 27, 1980, HHS amended its department wide grants administration regulation by dropping the requirement for the submission of copies of nonfederal audit reports (May 27, 1980 *Federal Register*, page 35328). On May 30, 1980, a supplement was published (*Federal Register*, page 36415) that included an HHS summary of the main provisions concerning audits in OMB Circulars A-102 and A-110:

"1. Each recipient must have itself audited by nonfederal auditors at least every two years.

"2. The recipient's auditors must meet certain standards of independence.

"3. The audit is to be performed on an organizationwide basis with appropriate sampling of grant-related transactions. Awarding parties may not impose grant-by-grant (or subgrant-by-subgrant) audit requirements."

In 1978, the first campus-provided audits of student financial aid were submitted. Major federally financed programs were being audited without any investment of resources by the HEW field audit staff. HHS began to appreciate this model and, it is speculated, began to look for ways to expand its application.

At about this time, the University of Pennsylvania engaged a CPA firm

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to provide an audit of its sponsored project activities. Harvard engaged a firm to assist in resolving questions resulting from HHS audits; subsequently Delaware, Houston, and Howard did the same. The assistance of CPAs was sought to demonstrate accountability and to have annual audits of a consistently high quality as well as, in some cases, to bring to closure the large dollar amounts subject to direct and indirect cost audits. Only one of these audits—Harvard's—was clearly considered to be an "A-110" audit. It is believed that HHS has used these five experiments, based on audits by Coopers & Lybrand and Peat, Marwick, Mitchell & Co., to develop an audit guide of its own.

The comptroller general of the United States published revised audit standards in 1981. Under the U.S. General Accounting Office (GAO) standard on independence, a third party (such as the HHS agency) can accept audit results only when the auditor is independent of the institution. The Department of Education has indicated that it intends to enforce this standard for all student financial aid audits required by regulation. Because of ED's position on the revised standards, many administrators have concluded that internal auditors lack sufficient independence to perform A-110 audits. This is an erroneous conclusion because, in its present form, A-110 does not require that audits be made for third parties. Following is the pertinent section of the GAO standard, until A-110 is formally changed:

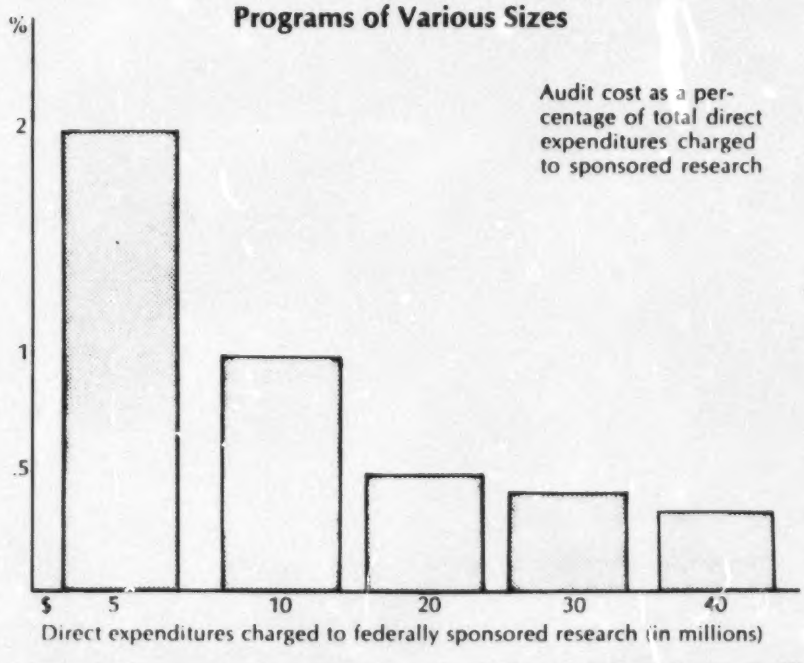
"The main objective of an internal audit staff is to serve the entity. Therefore, internal auditors may not be considered independent of the entity by third parties while auditing within their organization. While the internal auditor may not be considered independent, the external auditor, in auditing the entity, should use the internal auditor's work to the extent feasible after appropriate tests are performed."

Circular A-110 was developed to simplify administration, not to make procedures more detailed and complicated. The disproportionate consumption of audit resources by the student financial aid audits should warn institutions of the consequences of allowing HHS to implement audit guides for institutions. Although HHS officials initially assured auditors they would be able to exercise professional judgment in conducting the student financial aid audits, experience to date has indicated just the opposite. Many regional audit agencies are treating these "guides" as if they were law and have required compliance with every detailed step. In many institutions, these audits consume between 1,500 and 2,000 hours. The student financial aid guides are federal regulations, and changing them will be an arduous task. Institutions should be wary of increasing the existing problem of compliance with federal audit requirements by allowing additional and unauthorized guides to be issued. Within the three-campus University of Alabama System, one campus, with 74 percent of the system's enrollment, consumes over 30 percent of audit resources spent on student financial aid. The annual fee for the audit of financial statements on this same campus equals 11 percent of the total audit fee for the system. Without the student financial aid guidelines, an effective audit could be accomplished with one-third of the resources presently required. The conclusion to be drawn is that when federal audit guides become sufficiently complex, audit resources are consumed without regard to size of the program.

The major research universities have committed and undoubtedly will continue to commit substantial resources to auditing their U.S.-sponsored research activities. Smaller institutions and institutions with a relatively low volume of research will have difficulty complying with a federal audit guide. Exhibit 1 serves to illustrate the disproportionate effect on overhead that A-110 audits might have. One way to assure some degree of equity among institutions is to relate the percentage of resources spent on A-110 audits to sponsored research volume. The main point is that a balance between quality and cost effectiveness must be found and maintained.

As more audits are required to meet regulatory requirements, institutions must either increase their audit budgets or reduce the number of nonregulatory audits. The latter approach would result in sacrificing audits in many critical areas such as computer centers, athletic events, hospitals, bookstores, payroll and personnel, and investments. Institutions must resist the imposition of unnecessary external priorities on their operations and should retain control to the extent possible over the assignment of audit priorities. The federal government's

Exhibit 1: Impact of a $100,000 Audit Fee on the Overhead of Research Programs of Various Sizes



procedure for determining its audit priorities is found on OMB Circular A-73. The following is quoted from that circular (revised, March 15, 1978, Paragraph 7,8 b).

"Determination of audit priorities. Each agency will establish procedures requiring periodic review of its individual programs and operations to determine the coverage, frequency, and priority of audit required for each. The review will include consideration of the following factors:

"1. Newness, changed conditions, or sensitivity of the organization, program activity, or function;

"2. Its dollar magnitude and duration;

"3. Extent of federal participation either in terms of resources or regulatory authority;

"4. Management needs to be met, as developed in consultation with the responsible program officials;

"5. Prior audit experience, including the adequacy of the financial management system and controls;

"6. Timeliness, reliability, and coverage of audit reports prepared by others, such as state and local governments and independent public accountants;

"7. Results of other evaluations; e.g., inspections, program reviews, etc.;

"8. Mandatory requirements of legislation or other congressional recommendations; and

"9. Availability of audit resources."

Institutions should zealously guard the same latitude in establishing their priorities. Audit of the grant and contract activity function is laudable. Undoubtedly, both institutions and the federal government will benefit from the process. However, colleges and universities should be given an opportunity to meet this requirement without the burden of additional detailed procedures such as those found in federal audit guides.

Some officials in HHS will argue that recent budget cuts make it necessary for them to rely on non-federal audits to a greater extent than ever before. For two reasons, however, these audits will be much more expensive than audits previously done by the HHS Audit Agency. First, training costs per audit will rise. With HHS, training resources were controlled and allocated on a national basis. If HHS is successful in having A-110 changed, each institution will select a CPA firm to audit its grants and contracts. It will be necessary for firms nationwide to learn how to audit these programs, and someone must pay the bill for their training.

A federal auditor with 1,500 assignable hours a year who earns $30,000 has a charge-out rate of $20 per hour. Adding 25 percent for overhead brings the rate to $25. The rate for a comparable employee of a CPA firm will be considerably higher; the higher rate is largely a function of the profit margin. Again, someone must pay the bill.

Institutions with large volumes of sponsored research and that have not been audited by HHS for several years are concerned about the financial exposure from potential audit disallowances. Although A-110 does not mandate third-party audits, institutions in this category can benefit from having CPAs or state auditors audit their grant and contract activity. For example, an institution with $200 million in federally sponsored research and that is audited by HHS every six years could have a commendable error rate of only 0.2 percent. But, when applied to a six-year period, the institution has a potential disallowance of $2.4 million. With more frequent audits, problems are detected earlier. The institution is able to correct its systems sooner, which reduces audit disallowances to a much more acceptable level. An institution with a high research volume or a high expected error rate, or both, certainly can justify the payment of audit fees. Other institutions cannot.

For those institutions wishing to voluntarily provide third-party audits in lieu of cognizant audit coverage, there is need for an agreed-upon approach. Some believe this could be in the form of an audit guide. Under ideal circumstances such an audit guide would be developed as follows:

1. The guide should be under the auspices of OMB. This would allow institutions not under HHS audit cognizance to use the guide.

2. The guide and the audit procedure should be completely voluntary. This would allow each institution to decide whether it should incur the expense of the audit.

3. The guide would completely satisfy A-110 requirements. Any institution engaging a CPA to perform a third-party audit would be considered to be in compliance with the A-110 audit provision.

4. The guide, once adopted, should not be subject to frequent changes.

5. The guide would allow the CPAs or state auditors to exercise judgment in the selection of areas to evaluate and to determine the extent of testing necessary in the circumstances.

6. The guide would permit internal audit departments with a high level of independence to do A-110 audits.

All institutions with sponsored research must comply with the audit standards in A-110. Under A-110, institutions are not required to perform third-party-type reviews. Some may wish to do so voluntarily. In those cases, the audits should be conducted under a reasonable set of uniform standards that apply to all institutions choosing to provide audits for their cognizant agency.

Others believe that additional audit guides are unnecessary. They believe that A-21 and A-110, combined with generally accepted auditing standards, provide all the necessary guidance. The most ardent of the above contend that the proposed audit guide serves CPA firms that are anxious to expand their market and HHS auditors who want to transfer the burden of direct cost audits to the institutions. The higher cost for these audits will be funded from ever-shrinking research funds.

Although an audit guide appears to be unnecessary, it appears inevitable that there will be a strong push by CPAs and HHS to implement one. Many issues must still be resolved.

1. How would development of an audit guide relate to the attempt by the HHS Audit Agency to have institutions perform "on-line" audits?

2. If internal auditors are sufficiently independent to perform "on-line" audits, as has been the case, why are they not sufficiently independent to continue to perform A-110 audits?

3. Why are special audit standards needed for federal restricted funds?

4. With the inadequacy of research funds nationally, would it not be prudent to look for alternative solutions, such as a supplemental schedule to the annual financial statement, which could be included in the annual audit at a small incremental cost?

Federal funds need to be audited. The audits should be cost-effective, timely, and efficient. Both COGR and NACUBO will continue to participate in and to monitor these developments. ♦

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